BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

February 10, 2009

Mr. Gerald Parsky
Chairman, Commission on the 21st Century Economy
c/o Department of Finance
915 L Street, Eighth Floor
Sacramento, CA 95814

Dear Mr. Parsky:

Congratulations on your appointment as Chairman of the Commission on the 21st Century Economy. The Commission's work could not be more timely – or needed. The accumulated harm inflicted on California by the economic recession, credit crunch and budget crisis demonstrates clearly how crucial it is that policymakers closely examine, and fix, our fiscal structure. The Commission's charge to analyze the State's tax system is a crucial part of this undertaking.

In October 2007, in recognition of my responsibilities as State Treasurer, my office published a review of the State's debt capacity, *Looking Beyond the Horizon: Investment Planning for the 21st Century*. The report places General Fund debt payments in the context of the State's overall fiscal condition.

Using a "current services" analysis, and assuming the maintenance of our current expenditure and revenue structure, the report found the State can expect to run a chronic annual deficit of between three percent and four percent over a 20-year period starting in 2008-09. In the review, we recommended the State address its fiscal structure – both the revenue and expenditure sides – to ensure it could continue financing its operating and debt commitments.

We recommended the Legislature and governor take a studied approach, noting that corrections to the State's fiscal structure could be made over time. The 2007 report explicitly assumed a full-employment economy and continued global financial stability. As we now know so painfully, a recession and a global liquidity crunch have played havoc with our State and local government budgets.

Nevertheless, I do not recommend hasty actions. When commenting on the world economic situation, the former Archbishop of Canterbury, George Carey, provided this perspective:

> *We have been in worse crises than this and you might have assumed from all the doom and gloom that Armageddon is about to happen. Let's get a sense of proportion about it all and let some faith in our abilities return.*

I am confident that when the municipal bond market recovers and the economy improves, California can build and maintain a balanced budget and prosper once again. Another reason to take the time needed to complete the job: The Commission's work is less about today than tomorrow. After all, it's the Commission on the 21st Century Economy, not the Commission on Getting Us Through the Next Two Years. So, I believe the Commission should make the central objectives of its work long-term planning and durable solutions, not any short-term agenda. With the future the focus, the Commission should proceed with patience, care, diligence and solid evidence.

Because many of the goals the Governor set for the Commission in the Executive Order require State revenues to be not only stable but adequate, a serious, credible and long-term estimate of California's funding needs will be useful in considering and completing your report. Fortunately, much good work on our state's future demographics, and the cost of providing services and infrastructure, already has been completed. My office stands ready to help the Commission access such studies and put them to good use.

I would like to be as helpful as I can to you and the Commission. With that in mind, my office has updated with the enclosed paper some of the recommendations in our 2007 report, and included a new section on "Volatility: Foe or Friend?" which is of special note. I look forward to the Commission's report and recommendations. There could not be a better time to chart a responsible course to California's future. If I or my staff can assist, please don't hesitate to call me.

Sincerely,

Bill

BILL LOCKYER
California State Treasurer

Enclosure

Faith in our Abilities

Considerations for Protecting the State's Debt Service Payments

On October 1, 2007, the State Treasurer issued the annual debt affordability report, *Looking Beyond the Horizon: Investment Planning for the 21st Century*. It found that to get ready for tomorrow, and make present-day California a place where everyone has a real opportunity to enjoy a good life and make a good living, the state needed to replace, invigorate and modernize its decaying public infrastructure. Our schools, highways and parks, and our transportation, water delivery, conservation and flood control systems, all need attention after decades of neglect.

Figure 1
Comparison of Estimated General Fund Balance
2008-09 through 2027-28
Dollars in Billions

FISCAL YEAR	OPERATING EXPENSES (BEFORE DEBT SERVICE)	REVENUES	REVENUE BALANCE
2008-09	$ 106.8	$ 107.1	$0.3
2009-10	111.8	113.6	1.8
2010-11	114.2	120.7	6.5
2011-12	120.6	127.7	7.1
2012-13	126.8	133.6	6.8
2013-14	133.2	139.4	6.2
2014-15	139.9	145.6	5.7
2015-16	146.4	152.0	5.6
2016-17	153.5	158.7	5.2
2017-18	160.7	165.7	5.0
2018-19	168.2	173.0	4.8
2019-20	176.0	180.6	4.6
2020-21	184.2	188.5	4.3
2021-22	192.8	196.8	4.0
2022-23	201.8	205.4	3.6
2023-24	211.1	214.3	3.2
2024-25	220.8	223.6	2.8
2025-26	231.0	233.3	2.3
2026-27	241.6	243.3	1.7
2027-28	252.6	253.8	1.2

Methodology of the 2007 Report

The Treasurer's staff estimated General Fund revenues and expenditures for the 20-year period starting in 2008-09. To make the calculations, staff used the Legislative Analyst's projections for 2008-09 through 2011-12 (contained in the LAO's 2006 *Fiscal Outlook*). For the remaining years, staff

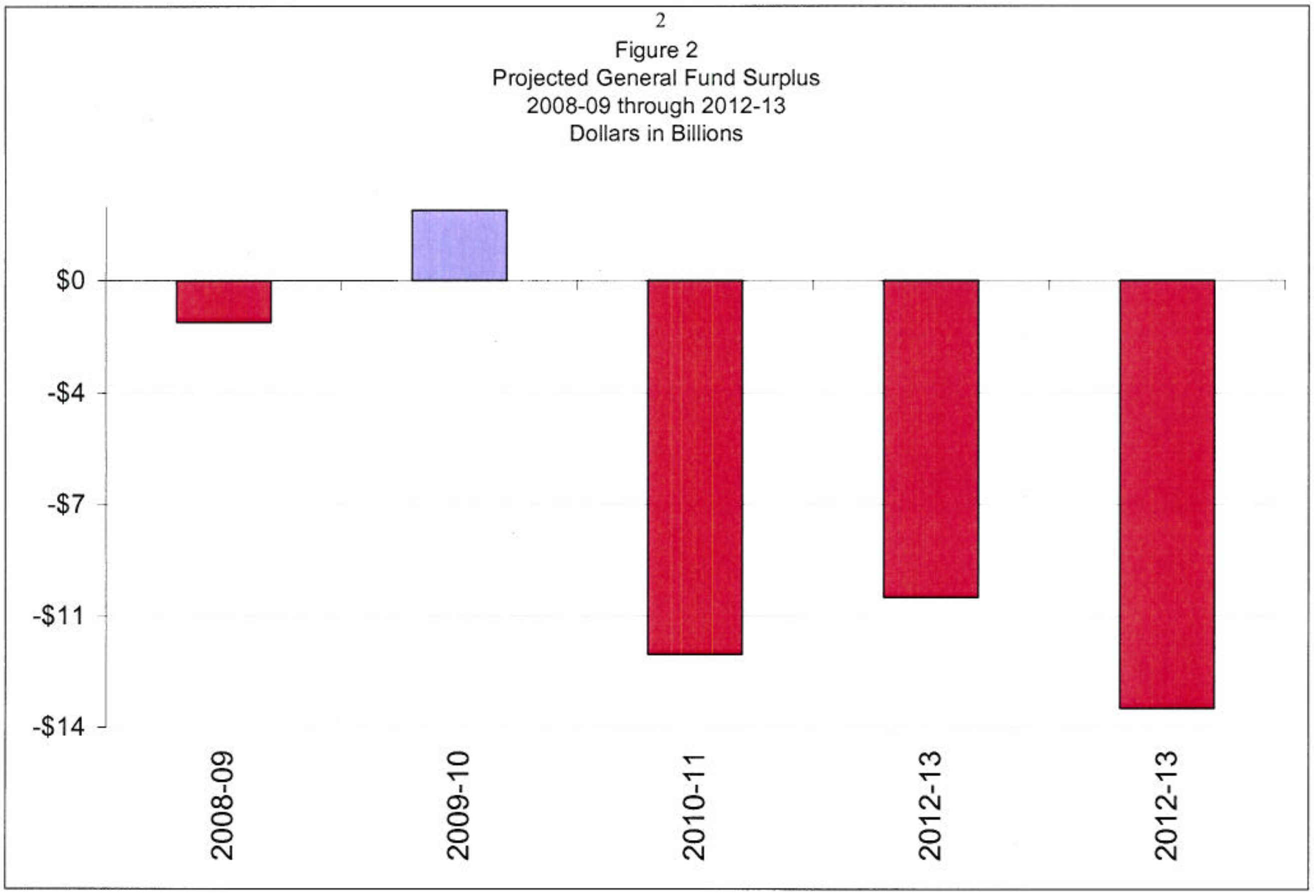
used long-term inflation and population factors to adjust for growth in broad programs and taxes. Using these calculations, staff compared the State's operating expenses (before debt service) and revenues. The comparison, displayed in Figure 1, shows the State could expect a *positive annual revenue balance* of between $300 million and $5.7 billion during the estimate period. This balance would be available for financing debt service, program expansion, tax cuts, revenue shortfalls or unanticipated expenditures.

After accounting for the State's growing debt service and its constitutional reserve requirements, however, staff estimated that without any change to the State's fiscal condition or structure, the General Fund would run an *annual deficit*. The deficit would average between three percent and four percent of General Fund revenues.

The staff estimates explicitly assumed away business-cycle volatility and changes in global finances. Since the estimates were made, to put it mildly, the state's economy and global finances have experienced significant stress. The State Department of Finance (DOF) reported (*Governor's Budget, January 9, 2009*):

> ***...the California economy decelerated in step with the national economy during 2008. According to the U.S. Commerce Department, total personal income grew more slowly in the second half than in the first half of 2008. The deceleration in taxable sales has been even faster, with third quarter 2008 sales 4 percent lower than second-quarter sales. Deceleration in new vehicle registrations started earlier — in 2007. The state's monthly job losses have grown as 2008 has progressed. Through November, California lost 147,400 jobs, or 13,400 jobs per month.***

DOF further estimated that both the national and state economies will be weak at least through the first quarter of 2009. How soon will we see recovery? "Difficult to gauge," DOF said.



Since the Governor's budget presentation, the national and state economies continue to erode, with another sharp 4th quarter drop in GDP, and the month-to-month loss of another 600,000 U.S. jobs.

The Governor proposes several major changes in the General Fund tax, debt and expenditure structure. Even if the Legislature adopts all the proposed changes, however, DOF estimates the State will continue to run annual General Fund deficits exceeding $10 billion as far as its crystal ball can see. (Please see Figure 2.) In fact, the DOF estimates suggest the State's budget deficits could continue even after the California and global economies improve.

The State's fiscal condition is central to the Treasurer's ability to manage California's debt and investments.

In the current municipal debt market, wracked by credit scarcity and anxiety about market stability, the State's financial health has become a greater concern among investors. The State's debt service payments will not be affected by the deficits identified by DOF. Nor would they have been affected by the smaller shortfalls identified in the 2007 debt affordability report. However, chronic and rising deficits raise a broader concern about our state's future: How will the State afford both the infrastructure needed to serve our growing population <u>and</u> essential services such as schools, health care and public safety?

Fiscal concerns also require the Treasurer to manage, together with the Governor, Department of Finance and State Controller, California's short-term cash needs. The flow of tax revenues into the State's coffers is uneven from month to month, sometimes high and sometimes low. Meanwhile, expenditure levels stay fairly constant. This creates periodic cash imbalances that require the State to use cash-flow borrowing even in good times. But the continuing budget deficits – and devices used to balance the State's books – have forced the State to take out larger loans to meet its monthly payments than would have been required with a balanced budget. This short-term borrowing has made the State vulnerable to the recent havoc in credit markets. For example, the State faced extraordinarily high interest rates for its cash-flow financing in the last quarter of 2008, and was unable to borrow the full amount needed.

The State's extremely poor cash position is a symptom of California's larger fiscal problem. Indeed, the cash shortage and chronic budget deficits share the same cause: the persistent failure to match revenues and expenditures.

Planning for the Rest of the 21st Century

When it comes to the importance of long-term thinking, planning and action, the Executive Order (S-12-08) which created the Commission on the 21st Century Economy says it best: "California is *and should remain* the best place in America to live, work and raise a family." To secure the future, we will need a sound, stable fiscal structure.

Unfortunately, fiscal stress has been mounting for at least a decade; some say the trouble can be traced back 30 years. During this time, policymakers did the best they could, and likely would agree with the sentiment of novelist Robert Graves:

> ***...if condemned to relive those lost years, I should probably behave again in very much the same way.***

As described in our 2007 debt affordability report, the fiscal decisions made, and actions taken, in any particular year ripple into the future. That makes it crucial that we start now to fix our entire fiscal structure – taxes, spending, debt and reserves. In undertaking this endeavor, the following principles should be kept in mind:

1. ***Measure and Meet the Needs of Future Generations.*** **California's post-war expansion astonished the rest of the country. Scholars around the world study the state's agricultural prowess and search for the secret of success in the Silicon Valley, hoping to recreate California's prosperity. What will our next generation need? The basic requirements are known: education, health care, safe communities, environmental quality and top-notch infrastructure. The State's task is to build a tax structure that, in combination with other policies, ensures these needs can be met cost-effectively from today to 2020 and beyond.**

One of the biggest challenges in planning for the future concerns infrastructure. Building an infrastructure for the 21st Century will cost hundreds of billions of dollars. To their great credit, voters in 2006 made a $43 billion down payment on that investment when they approved a series of bond measures to finance infrastructure development.

But we have to fully acknowledge that every General Fund dollar we spend to pay off bonds is a dollar no longer available for vital services such as education, health care, environmental protection and public safety. So, as we suggested in the 2007 debt affordability report, if we decide to place a high priority on infrastructure, we also must develop reliable financing that reduces the burden on the General Fund. That will help ensure we can afford both the infrastructure and services our State needs to be livable.

2. ***Assess the Adequacy of Revenues to Meet Spending Commitments.***

   When the State establishes a worthwhile program, whether it is the university system or a health care service, Californians rightly expect policymakers will provide the financial security the program needs to sustain its work. Going forward, such commitments should be renewed in light of the State's likely ability to fully fund the program.

   In assessing sustainability, the State should accurately project its future costs against future revenue streams, document those projections in its annual budget, and avoid committing to expenditures that exceed forecast revenue streams.

The revenue structure should be calibrated to finance appropriate spending commitments. When considering sustainability, growth rates and volatility of the revenue streams are important considerations.

3. *Consider the Importance of Fairness and Incentives.*

The tax structure should not just be adequate, it should be fair. There are many measures and methods to assess the fairness of a tax, fee, or blend of taxes and fees.

But two features should be present in any fair tax structure. First, tax burdens should be evaluated and levied based on the ability to pay: The rich pay progressively more, the poor pay less and taxpayers with similar income and wealth pay the same amount. Second, taxes or fees also should be measured by the extent to which they fairly reflect costs and benefits: How much should those who receive the benefits pay? How much should those who impose the costs pay?

Obviously, the cost/benefit principle has common-sense limits. For example, it may be entirely appropriate to charge water users based on how much they consume. But few would suggest families living in poverty be forced to pay the full cost of health care and other services that help them survive.

We also tax activities that create social costs. We increase tobacco taxes to help cover the health care costs those products impose on the public. We raise alcohol taxes to reduce the public harm caused by excessive drinking. Or we levy a fee on paint manufacturers to fund lead poisoning tests of children. If the State imposed a tax on producers of climate change emissions, that would be another example.

Cost-based fees or taxes are designed, in part, to discourage, or provide an incentive to stop, behavior that imposes a burden on the general public. If successfully implemented, they can work over the long haul to reduce the size and cost of government. For example, the more we reduce cigarette consumption, the less taxpayers have to spend on treating tobacco-related diseases.

The state needs a broader discussion about the roles the tax structure and economic incentives can play in helping us meet the challenges facing California. Such a discussion should, among other benefits, provide direction to policymakers and tax administrators on methods to properly evaluate the costs and benefits of such proposals.

4. *Justify Tax Expenditures with Evidence.*

The effort to ensure the adequacy and fairness of California's tax structure should include a thorough, close examination of tax expenditures. Deductions, credits and loopholes cost the State billions of dollars every year. For each, we should ask: What are the public policy objectives? Are they being met? What is the cost? Does the cost outweigh the benefit? Who benefits?

The answers to these questions, and more, should be based on solid empirical evidence and sound data, where available. To ensure tax expenditures reflect sound economic and fiscal policy, and public priorities, the State should conduct regular assessments of these expenditures. Based on the findings of these reviews, policymakers should consider and decide whether to retain, modify or eliminate tax expenditures.

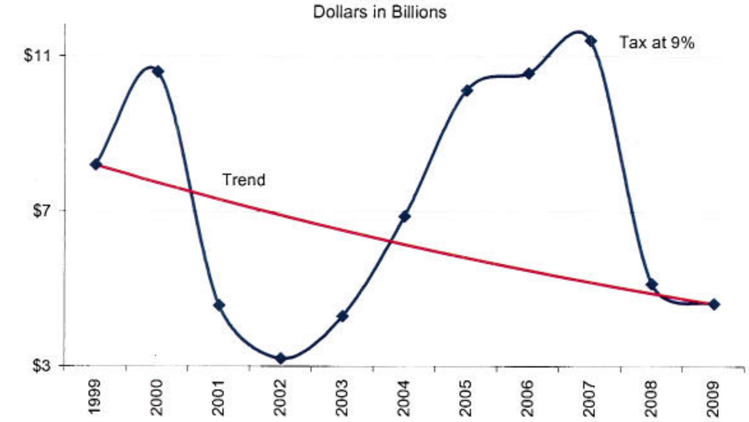
5. ***Consider State Taxes and Fees in the Context of Federal and Local Taxes and Fees.***

Californians pay taxes and fees imposed by the Federal and local governments as well as by the State. Taken together, they form a complex system of levies. When considering reform of the State tax structure, the interaction of these taxes and their aggregate impact on individual and business taxpayers should be considered.

For example, when the State expands its sales tax base, it also expands the tax base for cities, counties and special districts. More broadly, the State/local tax structure is part of the State's overall fiscal system. To the extent the Legislature can reduce local costs or increase local revenue capacity, it helps strengthen the State's overall finances.

The connection between taxes paid and public benefits should be made clearer and more easily understood at every level of government. This will increase public trust and improve public participation in planning and deciding our future. More simplicity, more logical tax and governance relationships, and more and better communications with Californians about their taxes and services should be important objectives as we build the state's 21st Century economy and fiscal structure.

Figure 3
Tax on Capital Gains (assumes 9% tax rate)
1999-2009
Dollars in Billions



Volatility: Foe or Friend?

Many experts and policymakers have raised con[3]rns about the tax system's "volatility," that is, the year-to-year variation in receipts. One concern arises from a planning perspective: Unpredictable tax receipts complicate the budget-making job of the Legislature and governor. Another concern regards revenue erosion: If tax receipts fall dramatically from one year to the next, then the State's ability to meet its responsibilities will be compromised.

Critics who contend the State's tax structure is "too volatile" often point their finger at rollercoaster receipts from capital gains taxes. Figure 3 displays the revenue derived from income taxes on capital gains for the 11-year period starting in 1999. It shows large, multi-billion dollar swings from one year to the next. The magnitude of this annual change is not typical of the overall income tax or any other General Fund tax. Moreover, the capital gains trend line actually reflects more predictability than volatility. As shown in the figure, capital gains receipts have dropped an average of 5.6 percent annually since 1999.

Some propose reducing the tax rate on capital gains as a way of reducing the effects of "volatility." But the State would pay a heavy price if it made such a move. Consider: If the State had cut the capital gains rate from 9 percent to 5 percent over the period covered in Figure 3, it certainly would have experienced less extreme variations in receipts. But it also would have given up $35 billion in revenues from Californians who can most afford to pay taxes.

The tax proceeds from capital gains have been identified as "volatile," even though the long-term trend for the income tax has been a steady average annual growth rate of seven percent. In recent years, sales and use, corporation, and local property taxes also have had year-to-year growth or decline that was inconsistent with their long-term trend line.

Volatility is not the bogeyman portrayed by critics. Our economy is intrinsically volatile. It's prone to ups and downs, and sometimes those changes are large and abrupt.

If we want our tax structure to reflect our 21st Century economy, we have to accept revenue swings as a fact of life. When the tax structure fails to keep pace with the economy, because it is based on an incomplete reflection of that economy, the likelihood increases that tax rate hikes will be necessary to remedy fiscal shortfalls. But history and human nature tell us that policymakers always will be more likely to postpone rather than enact such rate increases, no matter how necessary. That does our long-term fiscal health no good. If tax reforms perpetuate a system which forces too-frequent consideration of rate increases, those reforms are politically and practically useless.

We shouldn't view volatility as the enemy. In fact, it can be our friend, if managed properly. Volatility critics focus on the down slopes. But the up slopes provide the State substantial windfalls. Our goal should not be to eliminate volatility, but to ensure that when the receipts rocket skyward, we have a parachute for the inevitable fall.

In short, volatility has not put us in dire fiscal straits; inadequate fiscal management has. In essence, the lack of skillful fiscal management is a technical problem. But two often-suggested solutions to the problem – reducing capital gains tax rates and/or a "hard" spending cap -- are much more than technical. Both are major policy decisions that hold huge implications for reducing the fairness of our tax structure and the range of choices our lawmakers must have to craft budgets that reflect the public's priorities and needs.

As discussed above, one measure of the fairness of taxes is whether the burden is based on the ability to pay. The capital gains tax, since it falls primarily on the wealthy, is an important

contributor to the fairness, or progressivity, of California's tax structure.

And since 1995, the wealthy have done pretty well in California.

State Franchise Tax Board data show that, from 1995-2006, the adjusted gross income of the richest one percent of California taxpayers more than doubled (108.4 percent increase). That compares to a 10.8 percent increase for the lowest-earning 20 percent of taxpayers. The result is that California's wealthiest one percent, who received 13 percent of all California income only 10 years ago, absorbs 26 percent today. If California cut the capital gains rate in an effort to reduce volatility, our state would shift its tax burden even further from those who can afford it to those less able to pay. If that happens, we will sacrifice fairness in an ill-conceived pursuit of stability.

The most commonly-discussed spending cap scheme allows government spending to increase by no more than the combined growth in inflation and population. By limiting the State's ability to spend the tax revenue it receives, such a spending cap helps address income volatility. But it does so by ignoring economic production altogether. As a result, it hamstrings the State's ability, when the economy is booming, to prudently use increased wealth to provide better schools for our kids, or to make our communities safer and our families healthier.

Any solution to the technical problem of fiscal management should be neutral on the policy question of how much money taxpayers, and those they elect, decide to raise or spend for government services. Here's one idea:

The State could set aside in an account all capital gains proceeds it receives each year. But the State would not recognize the proceeds as revenue for budgeting and spending purposes. Instead, each year it would only recognize as revenue, and spend, the average amount of capital gains taxes deposited

in the fund over the previous five years. That way, the peaks and valleys of revenues would be considerably evened out.

Applying this approach to our recent history:

Between 1999 and 2009, annual capital gains revenues ranged from $3.2 billion to $11.4 billion. Average annual revenues were $7.5 billion, but the average change in revenues from one year to the next was $2.7 billion, or 36 percent of average annual revenues. If, instead, the State had recognized and spent the average of the previous five years' receipts, during the years 2004-2008 the year-to-year difference would have averaged only 10 percent of average annual revenues. And the maximum year-to-year change would have been only $1.6 billion. So, without changing the rates, this approach would have reduced the volatility of the capital gains tax by roughly 70 percent.

Given the State's current year-to-year budgeting practices, and rigid schedule for estimating and "scoring" revenues, implementation of such a plan would require budget-makers to employ a different method for calculating capital gains revenue. Such a new approach probably would include an annual "look-back" provision, and require mid-year corrections. But it's an option that should be seriously considered because the payoff in better budgeting and readiness for the future likely will be well worth the effort. And it's only one alternative. Other approaches suggested by experts include setting aside in a reserve or designating strictly for one-time expenditures any windfall revenues from capital gains or other taxes.